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CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1933.

No. 158

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

CHARLES J. CANFIELD,

Respondent.

CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF IN BEHALF OF RESPONDENT, CHARLES J. CANFIELD.

EDWIN H. CASSELS,
Attorney for Respondent.

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CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF IN BEHALF OF RESPONDENT, CHARLES J. CANFIELD.

I.

Official Reports of the Opinions Delivered Below.

The opinion of the Circuit Court of Appeals for the Seventh Circuit in this case is found in 62 Fed. (2d) 751. The Findings of Fact, Opinion and Decision of the Board of Tax Appeals are reported in 24 B. T. A. 480 (Trans., 22).

II.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered January 13, 1933 (Trans., 46). The petition for a writ of certiorari was filed on June 10, 1933, and was granted on October 9, 1933. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

II.

Statement.

This case is a companion case to *William R. Thorsen, Petitioner,* v. *Guy T. Helvering, Commissioner of Internal Revenue, Respondent,* No. 212, October Term, 1933, 65 Fed. (2d) 234.

The facts are identical save only that Canfield, the Petitioner in this case, did not have as many shares of West Side Lumber Company stock as did Thorsen and hence did not receive so large a dividend payment.* The point of law to be decided is the same in

* Canfield originally returned 16.35 per cent of the dividend received by him, or $33,360, as taxable. If his contentions herein be upheld the taxable per cent of the dividend will be 14.91 per cent. The difference between these two figures is due to certain errors in the original income tax return of West Side Lumber Company, which were later corrected by the Commissioner. Canfield in making his return followed the figures in the Company return. Therefore, if the percentage of 14.91 be correct, he is entitled herein to a refund, as he should have reported $30,414, instead of $33,360, as taxable. (He also reported a dividend of $6,000 received by him on February 12, 1923, about which no question is raised.) Because the recomputations by the Commissioner in his review of the return of West Side Lumber Company lowered its net income, $6,879.29 of the dividend of April 14, 1923, paid before that review, was in fact paid out of paid-in capital.

both cases. The Circuit Court of Appeals of the Seventh Circuit in this case reversed the decision of the majority (eight members) of the Board of Tax Appeals and accepted the view of the dissenting minority of seven members. The Circuit Court of Appeals for the Ninth Circuit affirmed the decision of the majority.

The Petitioner Thorsen in case No. 212 is represented by counsel who represent the Respondent Canfield in this case. A brief has been filed for the Petitioner in the Thorsen case. In the interest of brevity, the Respondent here adopts and incorporates herein by reference the brief for Petitioner in the Thorsen case.

Thus, this brief is not designed as a complete argument. It is designed only to deal with such parts of Petitioner's argument as were not adequately treated in the other brief.

IV.

Summary of Argument.

I.

The statute fixes two periods with respect to the taxation of dividends—one beginning March 1, 1913, and the other ending on February 28, 1913. Dividends paid from earnings and profits accumulated after March 1, 1913, are taxed; all other dividends are tax-free. The amount accumulated during the taxable period is the excess of profits over losses for the entire period.

II.

The Petitioner has improperly construed Section 201 of the Revenue Act of 1921. He has given a wrong meaning to the word "accumulated" and has improperly determined the amount of Respondent's dividend subject to tax.

III.

There is nothing to show that the administrative practice of the Bureau of Internal Revenue received the implied approval of Congress. The Bureau by misinterpreting a statute cannot bind the courts to an erroneous conclusion nor can it require Congress to pass legislation to correct its errors.

V.

ARGUMENT.

I.

The Construction of the Statute and Its Application to the Facts of This Case.

This controversy grows out of the assertion by Petitioner (the Commissioner of Internal Revenue), of the right to assess and collect an additional income tax because of the receipt by Respondent (the taxpayer) of a dividend from West Side Lumber Company. Both the Commissioner and the taxpayer agree that part of this dividend should be taxed and that the balance should be tax-free. Both agree that the part subject to tax is that part paid out of the earnings or profits of the corporation "accumulated since February 28, 1913". The taxpayer, in computing and paying his tax, determined the amount so accumulated by taking the difference between the profits and the losses—the income and the outgo—from February 28, 1913, to the date of the declaration of the dividend. He reported and paid his tax on that basis.

The Commissioner, on the other hand, approached the computation of the taxable portion of the dividend in a quite different way. Agreeing with the taxpayer as to the amount of the accumulations prior to March 1, 1913, but finding that the net operations for the next three years resulted in a large loss, he *excluded* this loss from his computation of the accumulations since February 28, 1913.

At the very threshold of the argument of the Commissioner we note the difference in his manner of approaching the problem. He is right in saying that the dividends paid out of accumulations before March 1, 1913, *might* have been taxed; and the taxpayer is right when he answers by saying that they are *not* taxed. It is all a matter to be determined by Congress; and Congress has said that only dividends paid out of accumulations after February 28, 1913, are to be taxed. The taxpayer approached the problem by endeavoring first to find out what *is* taxed. The Commissioner approaches the problem by endeavoring to find out what is *not* taxed. Therein, we submit, is the fundamental error of the Commissioner in this case.

This leads the Commissioner to say (Brief, p. 9) that the taxpayer must bring himself within an exemption. He stresses this point. It seems entirely clear that when the Commissioner asserts the right to collect a tax, it is for him to point out his authority to do so. But his argument seems to be that because Congress might have levied a tax on all dividends, he is relieved from that duty, and that for some reason there passes to the taxpayer the burden of showing that he is not subject to the tax.

Section 201 (a) determines what dividends only are taxed—those paid "out of earnings and profits accumulated since February 28, 1913". Section 201 (b) does not define the subject of taxation; it is purely supplementary to paragraph (a) and (so far as we are concerned here) merely provides that the taxable accumulations since February 28, 1913, must be distributed before the tax-free accumulations prior to March 1, 1913, may be distributed. This

provides nothing more than a sequence of distribution.

Section 213 of the Revenue Act provides that dividends are taxed, but 201 (a) defines the term "dividend" as used in Section 213. The question, therefore, is: what part of the dividend in this case was paid out of accumulations made subsequent to March 1, 1913? No more than that part may be taxed. Thus there can be no question of exemption. This case, therefore, is not a case for the application of the rule that an exemption is to be strictly construed against the taxpayer. Clearly it is simply a case of the construction of a taxing statute, which is to be construed against the Government and in favor of the citizen.

The Commissioner speaks (Brief, p. 13) of the "privilege" conferred by Section 201 inuring to the recipient of a dividend. We submit that there is nothing in this section which savors of conferring a privilege. Congress has the right to say what dividends shall be taxed and when it has said that certain dividends shall be taxed, it can only mean that others are not taxed; and the Commissioner does not go so far as to say that the receipt of tax-free income is a privilege.

The Commissioner, it would seem, has overlooked another very important point of Section 201, namely, that it creates two distinct and separate periods for tax purposes. Accumulations for the period after March 1, 1913, are taxed; all others are tax-free. It thus follows that the accumulations for each period are a fixed and static amount, not to be changed by happenings after the end of the period. The accumulations for the *period* after February 28, 1913,

must be the difference between the income and the outgo for the *period*. Thus, the taxpayer computed and paid his tax. Likewise it must be that the accumulations before March 1, 1913, were a fixed and definite amount determined *as of that date* and not subject to change by happenings after that date.

We submit that it is because of failure to recognize the two definite and distinct periods fixed by the law, that the Commissioner falls into the error in computing the amount of the tax in this case, of actually using three, and not two, periods. Beginning with March 1, 1913, there were three years where the aggregate losses were greater than the profits. During the following years up to the date of the declaration of the dividend, there were only profits. What the Commissioner has done (Trans., 13-14), in fact, is to take the aggregate of profits only of the period from March 1, 1916, to the date of the declaration of the dividend and then to assert that this aggregate is the profits "accumulated since February 28, 1913". He then takes the net loss for the intervening years 1914, 1915 and 1916 and says that it must be carried back and considered as a diminution of the March 1, 1913, surplus. If profits had preceded losses after March 1, 1913, the Commissioner would have computed the accumulations for the taxable period in precisely the same way as Respondent does; but because the losses came first he segregates three years from the taxable period created by the statute, and asserts his right to tax the accumulations from March 1, 1916, to the date of the dividend, wholly ignoring the declaration of Congress that the taxable period begins on March 1, 1913. Thus the Commissioner's construction of the statute apparently depends, not upon what it so

clearly says, but on the mere accident of the sequence of profits and losses.

The Commissioner says that it follows from the reasoning of the court below, that profits from 1917 to 1920 are considered as being earnings or profits accumulated prior to March 1, 1913. (Brief, p. 14.) He speaks of this as "unrealistic." It is apparent that the court below did not so consider any part of the profits earned after 1917. What the court below did was to interpret first that part of the law which defined what was to be taxed as having been accumulated during the taxable period beginning on March 1, 1913 and ending on the day of the declaration of the dividend. It determined that in order to find the accumulations during the taxable period after February 28, 1913, it must consider the period fixed by Section 201 (a) *in its entirety,* (and not certain years or separate years) and find the difference between the profits and the losses for all the years of the period. Thus it determined rightly, we submit, the amount subject to tax. It left the accumulations of the first period precisely as they were on the first day of March, 1913, a fixed and static amount. It dealt with the first three years' losses as if they were held in suspense and wiped out by the later profits, leaving a net profit or net accumulation for the period.

It would seem that throughout his whole argument the Commissioner has ignored the indisputable fact that Section 201 creates two distinct periods. This leads him at one point erroneously to state the issue (Brief, p. 15), and at another point to speak of the surplus of February 28, 1919 (Brief, p. 14).

What the surplus was at any time during the taxable period must be wholly immaterial in determining the surplus accumulated for the whole period. How to determine the accumulations during the taxable period after February 28, 1913, is the issue in this case.

After having properly construed the Act and defined the word "accumulated", the court below then said that the surplus as it existed on the first day of March, 1913, must be dealt with as if it were capital for the purposes of the act. We submit that the court below, in so construing the statute and computing the amount subject to tax, approached the problem properly and arrived at a sound conclusion. That surplus may be considered and dealt with under a tax law as if it were capital is well settled.* As was said in the dissenting opinion before the Board of Tax Appeals:

> "It seems to me too clear for controversy that any surplus existing on February 28, 1913, has no connection whatever with what the accumulated surplus since that date is." (Trans., 63.)**

Here, we submit, is the gist of the whole question. When Congress said, in effect, (in taxing only divi-

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* *Southern Pacific Company* v. *Lowe*, 247 U. S. 330. *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71. *Eisner* v. *Macomber*, 252 U. S. 189. *Lucas* v. *Alexander*, 279 U. S. 573. *Old Colony Railroad Company* v. *Commissioner*, 284 U. S. 552.

**The Board of Tax Appeals, in *Walker* v. *Commissioner*, 27 B. T. A. 829, in an opinion therein stated to have been prepared before (but which was announced after) the decision in this case in the Circuit Court of Appeals for the Seventh Circuit, squarely reversed its previous position and adopted the views asserted by Canfield, the respondent here, and Thorsen, the petitioner in the companion case. After the decision of the Circuit Court of Appeals of the Ninth Circuit in the Thorsen case, the Board refused to reconsider the Walker case, although Walker is a resident of the Ninth Circuit. It adhered to its decision in the Walker case in *Bouton: Garrett et al.* v. *Commissioner*, Mem. Op. March 10, 1933. Thus, the Board of Tax Appeals, the Circuit Court of Appeals for the Second Circuit in *Hadden* v. *Commissioner*, 49 Fed. (2d) 709, and the Circuit Court of Appeals for the Seventh Circuit, all accept the theory of the petitioner here. The only opposing decision is the one of the Circuit Court of Appeals for the Ninth Circuit in the Thorsen case.

dends from accumulations after March 1, 1913) that dividends paid out of surplus accumulated prior to March 1, 1913, were not to be taxed, it meant the surplus as it existed on that day—an amount which could neither be increased (this the Commissioner will concede) nor diminished by any subsequent occurrence, and if that is so, the Commissioner's argument fails.

The Commissioner says (Brief, p. 9) that the words upon which the taxpayer must stand or fall are certain words, which he quotes, in paragraph (b).

> "any earnings or profits accumulated * * * prior to March 1, 1913, may be distributed exempt from the tax."

This, we submit, is quite incorrect. These words are not the source of the Commissioner's authority to tax. And it is not the source of the taxpayer's right to receive a part of the dividend tax-free. The right of the taxpayer to receive a part of the dividend tax-free arises, instead, out of Section 201 (a). If paragraph (b) were struck from the act, the taxpayer's right clearly would remain. There was no paragraph (b) in the Act of 1916, but by Section 2 (a) of that act, the surplus of March 1, 1913, was distributable tax-free. Paragraph (b) performs only certain subordinate functions. It creates no primary rights whatever.

The Commissioner says (Brief, pp. 11-13) that the March 1, 1913, surplus is "hazarded" in the business, and that if losses occur, inasmuch as there is no express provision in the act for its replacement, it must be deemed "lost". This is but a bookkeeping conception. Congress has taxed only the earnings "accumulated since February 28, 1913." Hence,

there is nothing to tax until that period had shown an excess of earnings over losses. The tax is on such excess. By then the surplus of March 1, 1913, has of necessity been "restored". No express provision is necessary. The result follows of necessity from the language of paragraph (a) and is automatic.

II.

The Real Issue in This Case Is How to Compute the Taxable Portion of the Taxpayer's Dividend.

The Commissioner argues (Brief, p. 15) that it is important in computing how much of the earnings and profits a corporation has accumulated after February 28, 1913, within the meaning of Section 201, to determine whether the corporation had an earned surplus on that date. As a result, in construing the word "accumulated" the Commissioner would have it mean one thing if there was an earned surplus on March 1, 1913, and quite another thing if there was no such surplus. This, we submit, illustrates clearly a mistaken bookkeeping concept on the part of the Commissioner. If Congress has fixed two distinct and separate periods ending and beginning on March 1, 1913, and has declared that only the accumulations after that date are taxed, it means that the computation must begin on that date and end on the day of the date of the declaration of the dividend. If there were a deficit in 1913, instead of a surplus, that of course, would have to be made up, but the method of determining the accumulation would, in fact, remain the same under all factual situations, so that the court below was correct in accepting the rule laid down in *Hadden* v. *Commissioner,* 49 Fed. (2d) 709:

"and the accumulated profits since March 1,

> 1913, must necessarily mean the net excess of all profits between March 1, 1913, and the date of distribution, less all losses sustained between the same dates * * *"

As a matter of fact, it appeared in several cases* involving the same corporation whose dividends were under consideration in the *Hadden* case, that in reality there was a surplus on March 1, 1913,—growing out of the fact that the increase in the value of the company's assets was more than sufficient to offset the operating deficit. But irrespective of that fact, the rule laid down in that case is indubitably the correct rule for determining what are the earnings and profits of a corporation accumulated after February 28, 1913. This was the rule followed by the court below in this case.

The Commissioner asserts (Brief, p. 18) that the words "most recently accumulated earnings or profits" to the extent that they were accumulated since February 28, 1913, in paragraph (b) of Section 201 require earnings to be taken into the reckoning in the inverse order of their accumulation,—that is, the profits of 1923, then those of 1922, and so on, until the loss year of 1916 is reached. These words have no such effect. They were inserted in the 1917 Act to compel the distribution of 1917 earnings, bearing the war rates, ahead of 1916 earnings, bearing the pre-war rates. They were continued in the 1918 Act only as to "personal service corporations", and have been put in later acts solely because of the different tax treatment for a time (1918-1922) accorded to such corporations. They have reference only to differences as between the several years of the pe-

**Trustees* v. *Commissioner*, 15 B. T. A. 273; *Kountze* v. *Commissioner*, 17 B. T. A. 928; *Hadden* v. *Commissioner*, 17 B. T. A. 956.

riod *after* February 28, 1913, and have nothing to do with the mode of arriving at the taxable and non-taxable portions of a dividend as between the two periods before and after March 1, 1913.

That the Commissioner has misconstrued paragraph (b) is obvious from a mere reading of the 1916 and subsequent acts in the light of the situations they were designed to meet and what clearly they were intended to accomplish. The Commissioner says (Brief, p. 18) that the "plain import" of the language of paragraph (b) requires the reckoning to be made in the inverse order of the years, obviously overlooking the significant words *"to the extent that they were accumulated since February 28, 1913."* This is the whole story. We need not go beyond the words of the 1921 act. These words recognize the taxable *period* which the Commissioner ignores. In connection with the later words in the paragraph, they mean only (so far as they have application here) that a corporation must in effect distribute its earnings *"accumulated" during the entire taxable period* first and before it may distribute its accumulations as they were on March 1, 1913.

The Commissioner cites *Blair* v. *United States*, 63 Court of Claims 193. This case arose under the Revenue Act of 1918. The decision apparently was based, at least in part, upon subdivision (e) of Section 201 of the Act of 1918, which seems to have no application. This provision formed also a part of the 1921 Act (paragraph (f) of Section 201) which itself provided that it should "not be in effect after December 31, 1921."

The Board of Tax Appeals in *J. L. Washburn* v. *Commissioner,* 16 B. T. A. 1091, at 1098, had previously held the Blair case unsound and had declined to follow it. The Board in that decision understood the Blair case to be one where there was a capital deficit on March 1, 1913. The Commissioner claimed in that case that there was a surplus on March 1, 1913, of $106,460.51. He got this figure by considering the surrender of bonds and coupons of the par amount of $546,460.51 as a replacement of $440,000 of prior operating losses, and a contribution to surplus of the difference of $106,460.51. The court in its finding of fact 10, shows a net loss of $21,194.40 from March 1, 1913, to December 31, 1918. The question is stated in the opinion to be:

> "Where a corporation has a loss in excess of its gains *for the period of its corporate existence,* as well as for the period from March 1, 1913, to December 31, 1918, is a distribution of corporate funds to the stockholders in 1918 a taxable dividend within the meaning of the revenue act of 1918, or is such distribution a return of capital and therefore not taxable?" (Italics ours.)

As there was a net loss for the period after March 1, 1913, the condition of a loss *for the entire period of the corporate existence* could not be satisfied by a surplus of more than $21,194.40 on March 1, 1913. If the surrender of the bonds created a surplus, it would have been $106,460.51, instead of $21,194.40. If the surrender did not operate at all as creating a surplus, there was a capital deficit on March 1, 1913, of $440,000. If the surrender of the bonds be treated as having created a surplus as of March 1, 1913, such a surplus would clearly have been only a paid-in surplus and hence capital in its nature and on distribu-

tion non-taxable. Such a surplus would not change the facts as to an operating loss, if any, prior to March 1, 1913. It therefore would seem that the court treated the case as one where there was a capital deficit of $440,000 on March 1, 1913, a further (operating) deficit of $21,194.40 for the period March 1, 1913, to December 31, 1918, and an operating profit in the calendar year 1918 of $84,868.39, from which the dividend of $80,000 was paid in December, 1918. It said:

> "It was a distribution of its earnings and profits in 1918."

If there was a deficit in paid-in capital on March 1, 1913, the Blair case is obviously unsound, for no ordinary dividend could be paid by a corporation in that condition. The distribution would be from paid-in capital and hence would not be taxable income. If there was a surplus on March 1, 1913, arising out of the surrender of the bonds and coupons, still the decision, we submit, is wrong. In any event, it is of extremely doubtful value as an authority. The court does not mention the section of the 1918 Act corresponding to Section 201 (b) of the 1921 Act, on which the Commissioner relies here. *Edwards* v. *Douglas*, 209 U. S. 204, cited by it, depends on a statute totally different in language and purpose from the one before us. The opinion gives no reasons for the decision. It considers none of the arguments advanced here by either the Commissioner or the taxpayer. At best, the point of law decided is obscure.

III.

There Is Nothing to Show That the Administrative Practice of the Bureau of Internal Revenue Received the Implied Approval of Congress. The Bureau by Misinterpreting a Statute Cannot Bind the Courts to an Erroneous Conclusion Nor Can It Require Congress to Pass Legislation to Correct Its Errors.

The Commissioner makes the point that in this case he followed the established practice of the Bureau of Internal Revenue. On this point, we refer to pages 31 and 32 of the brief for Petitioner in the companion case of Thorsen (No. 212), October Term, 1933.

We submit that the judgment in this case was right and should be affirmed.

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